Internal Revenue Service

memorandum

TL-N-497-89
CC:TL:TS/MAKEYES

date: DEC 6 1988

to: District Counsel, San Jose W:SJ
Attention: Andrew Weiss

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted], Same Share Requirement for the Small Partnership Exception

This memorandum is in response to your October 19, 1988 memorandum requesting technical advice on how the recent cases of Harrell v. Commissioner, 91 T.C. No. 21 (1988) and Z-Tron v. Commissioner, 91 T.C. No. 22 (1988), impact on the [redacted].

ISSUE

How do the Z-Tron and Harrell opinions impact on the [redacted] as far as the same share requirement?

CONCLUSION

Under the "bright line test" set forth in Z-Tron and Harrell, there is no violation of the same share requirement of the small partnership exception in the [redacted]. Although we are not entirely satisfied with the "bright line test", we do not believe that this is the case to litigate the validity of that test. If we are to go forward with respect to the [redacted] year, we must be prepared to argue something other than the possibility of the same share requirement being violated as the court has clearly rejected the mere possibility theory, not only in Z-Tron and Harrell, but in the context of other issues as well. In these cases, however, we do not see any argument on the facts set forth to establish that the same share requirement was violated. Consequently, if we litigate the [redacted] year, taxpayers may be awarded attorney's fees in light of the Z-Tron and Harrell cases.

With respect to the [redacted] year, it is our understanding that the year is currently nondocketed and held open by a TEFRA statute extension. Our position regarding the [redacted] year is the

same as for [redacted]. Hence, we strongly recommend that you ascertain how many of the individuals' years may be open by 872's or 872-A's. If any are open, statutory notices should be issued.

FACTS

Your request for technical advice for the [redacted] involved the [redacted] and [redacted] taxable years. There are approximately [redacted] partnerships involved in the [redacted] year and [redacted] for [redacted]. Each partnership in the project had the same general partner for both years, [redacted] Each of the partnerships had one limited partner (with a few exceptions). The partnership returns and K-1's for [redacted] indicate that the limited partners contributed [redacted] percent of the capital and were entitled to [redacted] percent of the losses. However, the limited partners were only entitled to [redacted] percent of the profits, with the remaining [redacted] percent going to the general partner. No profits were earned during [redacted] or [redacted] Thus, only losses and research and development credits were passed through to the partners for those years.

On the partnership returns, Box M was checked yes, indicating that a partner in the partnerships was another partnership. However, the K-1's which are attached clearly identify each partner as an individual. It is unclear whether Box M was inappropriately checked yes or whether the general partner, [redacted], is a partnership.

For [redacted] there are approximately $[redacted] in adjustments for [redacted]. The [redacted] year was treated as TEFRA and an FPAA was issued. The [redacted] year has $[redacted] in adjustments. The [redacted] year is currently on a TEFRA statute extension.

The [redacted] and [redacted] years of [redacted] are scheduled for trial on [redacted]. [redacted] is assigned to the project.

DISCUSSION

As you recognize in your memorandum, there is a jurisdictional issue in the [redacted] as a result of the Z-Tron and Harrell cases. In Harrell, a statutory notice of deficiency was issued for the 1983 year disallowing petitioners' distributive share of the partnership loss and ITC. No items other than those covered in the partnership agreement were distributed for that year. Petitioners argued that disproportionate allocations were possible if certain partnership items not covered in the partnership agreement were distributed, therefore, the case should be dismissed for lack of jurisdiction as the small partnership exception was not applicable. The Tax Court denied petitioners' motion.

In Z-Tron, the reverse situation occurred. We treated the partnerships as TEFRA and FPAAs were issued. Petitioners filed motions to dismiss arguing that the small partnership exception applied. The Service argued that the differing triggering events for the shifting of interests in net losses and net profits violated the same share requirement. For the year in issue, however, the only items reported on the returns were losses. What actually occurred in Z-Tron was a shifting of interests in net losses; there was no actual disproportionate allocations. Hence, the court held that there was no violation of the same share requirement. 1/

The Z-Tron and Harrell cases are significant because in those cases, the court set forth a "bright line test" for determining whether the same share requirement of the small partnership exception has been met. The test provides that the determination should be made by examining the partnership return and K-1's (and any amendments filed prior to the commencement of the audit), considering only those items reported for the year in issue. The determination of this requirement should be made by the Service as of the date of the commencement of the audit.

The "bright line test" is contrary to the Service's current practice for determining whether the small partnership exception applies. Under existing procedures, the Service looks beyond the return to the partnership agreement and uses a facts and circumstances approach to arrive at the "correct" conclusion. However, we are less concerned with the portion of the "bright line test" which requires that we look only to the items reported for the year in issue, than we are with certain permissible types of disproportionate allocations.

Specifically, the Service's problem with the "bright line test" is that it conflicts with the temporary regulations, which provide in pertinent part as follows:

> If each partner's share of each partnership item would be the same as the partner's share of every other item, but for allocations made under section 704(c) or allocations made under similar principles in accordance with the regulations, the same share requirement of

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1/ Although we have decided not to appeal Z-Tron, we do not totally agree with the opinion. Accordingly, we are considering issuing an AOD acquiescing in result only.

> section 6231(a)(1)(B)(i)(II) shall be considered satisfied. Similarly, specified basis adjustments pursuant to sections 754, 743 and 734 shall not be taken into account in determining whether the same share requirement is met.

Temp. Treas. Reg. § 301.6231(a)(1)-1T(a)(3). Any of these above-listed special allocations or basis adjustments will bring a small partnership back into the small partnership exception, and the TEFRA procedures will not be applicable.

The temporary regulations conflict with the "bright line test" in that it generally will not be readily apparent from the partnership return and the K-1's whether any special allocations pursuant to section 704(c) have been made. Often, the revenue agent will need to look to the partnership agreement and the operative facts to make that determination. If the Tax Court test is followed, a partnership may be excluded from the small partnership exception, whereas under the temporary regulations, the partnership would still be within the exception.

We have reconciled the "bright line test" and our concerns regarding the inconsistency of the test and our temporary regulations by recommending that revenue agents first apply the "bright line test". If any disproportionate allocations are identified, a facts and circumstances test should be applied to determine if the disproportionate allocations are due to section 704(c) (or similar principles), or because of basis adjustments pursuant to sections 754, 743 or 734. If the disproportionate allocations are due to any of the above-listed sections, then it will be our contention that the same share requirement is not violated and the deficiency procedures should be followed. On the other hand, if the exception to the same share requirement set forth in the temporary regulations is inapplicable, the TEFRA procedures should be followed. We will defend before the Tax Court any case that meets this "dual" test.

It is our opinion that the "bright line test" requires revenue agents to look at each item shown on the return and K-1's, and determine if each reported item was allocated in accordance with the proper percentages; the agents cannot just look at Box D of the K-1's, showing percentages of profits and losses.

In the [redacted], the only items reported for the years at issue were losses (and credits for research and development, which are treated as losses). Although potentially there could have been a violation of the same share requirement if profits had been allocated, under the "bright line test" there was no violation since only losses were reported. Those losses were consistently allocated according to the K-1's, i.e., 100

percent to the limited partners. Therefore, there were no disproportionate allocations and there does not appear to be any argument to establish that the same share requirement was not satisfied, other than to rely on the possibility that the same share requirement would be violated in the event that both profits and losses were reported in the same year. However, the Tax Court has clearly rejected the mere possibility theory. 2/ Thus, unless we can devise an argument other than the mere possibility of a violation of the same share requirement, which we have been unable to do, we recommend that the same share issue be conceded.

In this regard, there is a strong possibility that attorneys' fees would be awarded to the taxpayers based upon Z-Tron and Harrell. This is an additional factor that militates against litigating the [redacted] year. While we recognize that substantial adjustments are involved in this project, we do not believe that these cases are distinguishable from Z-Tron with respect to the same share issue.

Notwithstanding the above, there is a possibility, albeit slim, that we can establish that the small partnership exception does not apply in these cases because the natural person requirement has not been satisfied. 3/ As noted previously, the partnership returns indicate that a partner in the limited partnerships is another partnership. However, the K-1's identify each partner as an individual. Although we are inclined to follow the information listed on the K-1's, if you have some other evidence that [redacted] was a partnership, or some

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2/ The Tax Court has rejected the mere possibility theory in other contexts as well, such as section 704(b) - substantial economic effect. In Dibble v. Commissioner, T.C. Memo. 1984-589, the court rejected the government's argument that since the partnership agreement did not require a partner to restore a deficit in his capital account, even though he never actually had a deficit during the year, the special allocation was invalidated. Cf. Goldfine v. Commissioner, 80 T.C. 843 (1983) (There was actually a deficit in the partner's capital account, therefore, the special allocation was without substantial economic effect).

3/ In order to qualify for the small partnership exception, in addition to satisfying the same share requirement, a partnership must have 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate. I.R.C. § 6231(a)(1)(B).

other type of nonnatural person, then the small partnership exception would not be applicable and the FPAA issued for [redacted] would be valid. Unfortunately, we have seen no real evidence to indicate that [redacted] is not a natural person.

Finally, we have the same recommendation regarding the [redacted] year. However, with respect to that year, we recommend that you check whether the [redacted] year is still open with respect to any of the partners based upon their execution of a Form 872 or 872-A. If so, statutory notices of deficiency should be issued to those partners.

Based upon the foregoing, we recommend that you apprise petitioners' counsel of the potential jurisdictional problem concerning the same share issue. Since our only argument is the mere possibility of a violation of the same share requirement, we should concede the jurisdictional issue and file motions to dismiss. However, if you believe you can make an argument that one of the partners is not a natural person, then you do not need to notify petitioner's counsel of a jurisdictional problem since the same share requirement would not be at issue because the small partnership exception would be violated on other grounds.

Attached hereto is a copy of a memorandum setting forth the position of the Chief Counsel's office regarding the duty of a District Counsel attorney to disclose an expired statute of limitations. Based upon that memorandum, we are of the opinion that you must apprise petitioner's counsel of the potential jurisdictional issue in these cases, but that you are not necessarily required to notify the court.

If you have any questions regarding this matter, please contact Marsha Keyes, Tax Shelter Branch at FTS 566-4174. Also, should you decide to litigate the jurisdictional issue, please advise us of your theory.

MARLENE GROSS

By: _____
HENRY S. SCHNEIDERMAN
Technical Assistant to the
Assistant Chief Counsel
(Tax Litigation)

Attachment:
As stated.

Internal Revenue Service
memorandum

AEstrada CC:TL

date:

to: Associate Chief Counsel (Litigation) CC

from: Director, Tax Litigation Division CC:TL

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subject: Duty to Disclose Expired Statute of Limitations

In reviewing the administrative file and preparing the answer to be filed with the Tax Court, an attorney in the Austin district counsel's office noticed that the deficiency notice had been issued after the statute of limitations had expired. Tax shelters were involved, but nothing in the file indicated fraud or a 25% omission of income was involved. The deficiency notice was not sent to district counsel for review prior to its issuance and memoranda in the file clearly indicated Examination was aware of the expired statute (attributable to faulty extensions). After advising Tax Litigation Division of the situation, district counsel filed an answer without mentioning the expired statute and then wrote to the national office for guidance.

General Legal Services concluded that the Model Rules of Professional Conduct do not require our attorneys to disclose an expired statute of limitations which petitioners must raise as an affirmative defense. Tax Court Rule 39 is consistent with the the proposition that petitioners' affirmative pleadings are required to raise a statute of limitations issue. Absent positive indicia of fraud, omitted income, or other reliable factors which may mitigate against expiration of the statute, we nevertheless favor a policy of giving notice to petitioners (or their counsel) advising them that the statute appears to have expired. To avoid the appearance of impropriety (and the possibility of attorneys' fees) the written notice should be sent to opposing counsel at or about the same time the answer is filed. Within a short period thereafter, district counsel should discuss the matter with opposing counsel and either concede the case or be prepared to defend against the issue.

By notifying opposing counsel, as opposed to the Tax Court, district counsel can adhere to high ethical standards and gain some valuable time which can be used to speak to the parties involved and determine with reasonable certainty whether the statute of limitations has in fact expired. Petitioners' representation by counsel should not be a factor in determining whether or not to advise taxpayers.

Additional Background Discussion

In the underlying Austin case, the Service and taxpayers signed two extensions restricted to issues pertaining to partnerships [redacted] and [redacted]. In the third year, partnership [redacted] was inadvertently omitted, but the error was corrected by a signed attachment to the form 872. On the fourth and fifth extensions, however, only [redacted] was covered and no mention was made of [redacted]. When the deficiency notice was issued, all adjustments pertained to [redacted], the partnership which had been omitted from the extensions. No adjustments were made with respect to [redacted].

Memoranda in the file indicate the chief (or acting chief) of Examination orally approved issuance of the notice based on the assumption that petitioners' counsel intended to extend the statute for both partnerships. Further inquiry into the matter indicates Examination was relying on cases where a taxpayer's name was misspelled or an identification number was incorrectly recorded. In those cases, however, the taxpayer and the scope of the extension could be readily determined from the face of the extension. The cases relied upon by Examination did not include instances where a partnership was excluded. We think that had Counsel reviewed the proposed notice in pre-90 day letter status, Counsel's legal advice would have been that the notice should not be issued.

In concluding that district counsel has no affirmative duty to notify the Tax Court, General Legal Services relies on Rule 3.3 of the Model Rules of Professional conduct, which provides that

> a lawyer shall not knowingly. . . make a false statement of material fact or law to a tribunal. . . .

Note, however, that ABA comments to the rule indicate "[t]here are circumstances where failure to make a disclosure is the equivalent of an affirmative misrepresentation". Although the comments do not expand on this statement, district counsel can easily avoid any suggestion of misrepresentation by notifying opposing counsel, checking the facts, and then advising the Tax Court, as outlined above.

The Austin situation can easily be distinguished from cases where taxpayers voluntarily present payment for taxes with respect to years for which the statute has expired absent fraud or substantial income omission. When taxpayers present payment on their own (i.e. other than in response to a Service initiated notice), the Service can more reasonably rely on taxpayer's better knowledge of the facts to support an assumption that the statute of limitations has not expired. (e.g. only the taxpayer knows if fraud was present).

Given the Tax Court's increasing willingness to consider ethical violations and impose sanctions on district counsel attorneys, affirmative action in notifying opposing counsel is favored whenever the possibility exists that the statute of limitations has expired. Such action may not be mandated by the rules, but it is the better course of action, especially in light of the current tightening of ethical standards in the area of Tax practice, which is being generally supported by the Service.

Since this is a policy question having potentially great significance, we wish your concurrence before advising District Counsel.

ROBERT P. RUWE

Attachments:
Memo from Austin District Counsel
Memo from General Legal Services